Balancing Policy

The Indian economy is in a very challenging position. A few years ago, India was shining with its economy growing at more than 8% per annum and had even touched a high of 10%. Hence the climb down to a decade low of 4.5% has been painful. Gross domestic savings which always hovered in the 30% to 36% bracket has slipped below 30%. Consumption too has been adversely impacted due to inflation and negative sentiments. While economic reforms have not kept pace with expectations, populist schemes have continued to be a source of expenditure. This coupled with our perennial reliance on oil imports to keep the economy chugging along has meant that today we have a huge problem of both fiscal and current account deficit.

The focus and attention on monetary policy has been higher than ever before. The Reserve Bank of India sees the need for investment as vital to revive the economy. High investments would unclog the supply side bottlenecks and thereby provide sustainable relief from inflation. However for capital investment to get the much needed shot in the arm, a competitive interest rate is necessary. At the same time staying the course of fiscal consolidation and improving governance are also necessary. In keeping with this requirement on 19th March 2013 the RBI cut the key repo rate, by 25 basis points to 7.50%.

Now let us understand how the implications of an interest rate cut can contribute in several ways:

1. **It will give a boost to Corporate profits:** In general, profits of companies get a boost when interest rates come down because the interest component of their cost reduces in accordance with interest rates. Nifty companies posted a meager 6.5% earnings growth in CY12 over CY11. But with government policy reforms taking shape and interest rates coming down, Nifty may see a higher earnings growth. Interest rate sensitive sectors such as banking & finance, automobiles, capital goods and infrastructure are likely to benefit when the cut in interest rate is passed on to the borrowers.

2. **Keep valuations attractive for foreign investors:** Foreign Institution Investor (FII) investments clocked $24.6 billion (2nd-highest ever FII flow in a calendar year) in CY2012, while total Foreign Direct Investment (FDI) investments clocked $46.6 billion (highest-ever

in a financial year) in FY2012. The FII inflow to the Indian equity market has been robust at more than $10 billion from January 2013 to March 2013. Clearly a reduced interest rate environment will create the platform for better corporate performance and hence this money can continue to flow.

3. Many projects have stalled because companies have not been able to make the promised infusion of equity, so banks are unwilling to make loan disbursements. A buoyant stock market will help companies raise equity & complete existing projects.

The challenge before the government in lowering interest rates is to ensure that inflation does not spiral upwards. In a high-inflation environment, savers turn away from deposits into stocks, gold, real estate and when stocks are not trusted and property is untouchably expensive, they embrace gold. This is what has been happening in India.

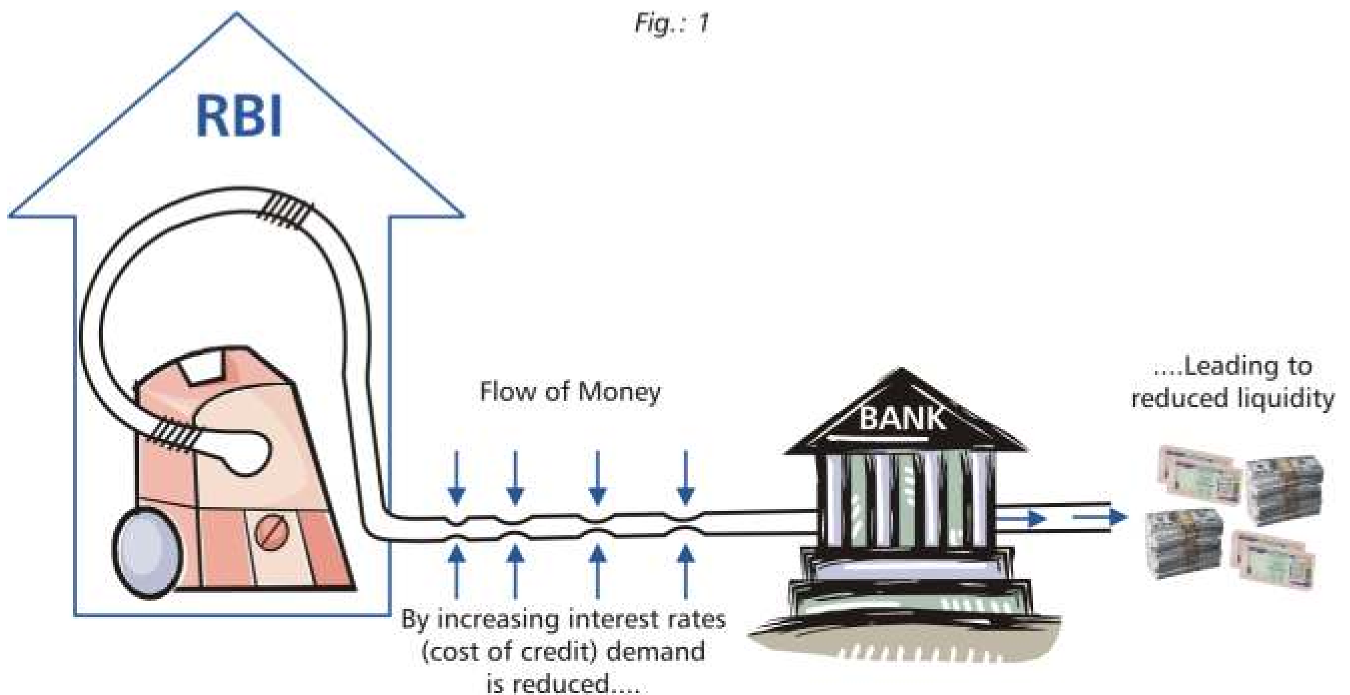
However, the Government seems to be committed to take forward reform measures in the months ahead. It appears, despite the mutually conflicting challenges of fighting high inflation and supporting low growth, one would clearly look forward to supportive monetary policy measures from RBI in terms of easier access to liquidity and lower interest rate to re-engineer the Indian growth story. The reason one can expect monetary policy to be conducive towards economic growth is that monetary policy alone cannot influence inflation beyond a point.

Eventually if there is a demand for goods and services the economy has to produce more to keep prices at check. This calls for a good investment climate. Monetary policy on the other hand keeps price under check by ensuring that people have less money on hand to buy more goods and services and thereby check demand and bring prices down. While it works in the short run, it is amply clear that this kind of a policy is not sustainable in the long run. Therefore fiscal consolidation and reforms are the way forward. Under pressure from the fiscal and current account deficit situation, the government seems to be decisively moving towards implementing reforms in right earnest.

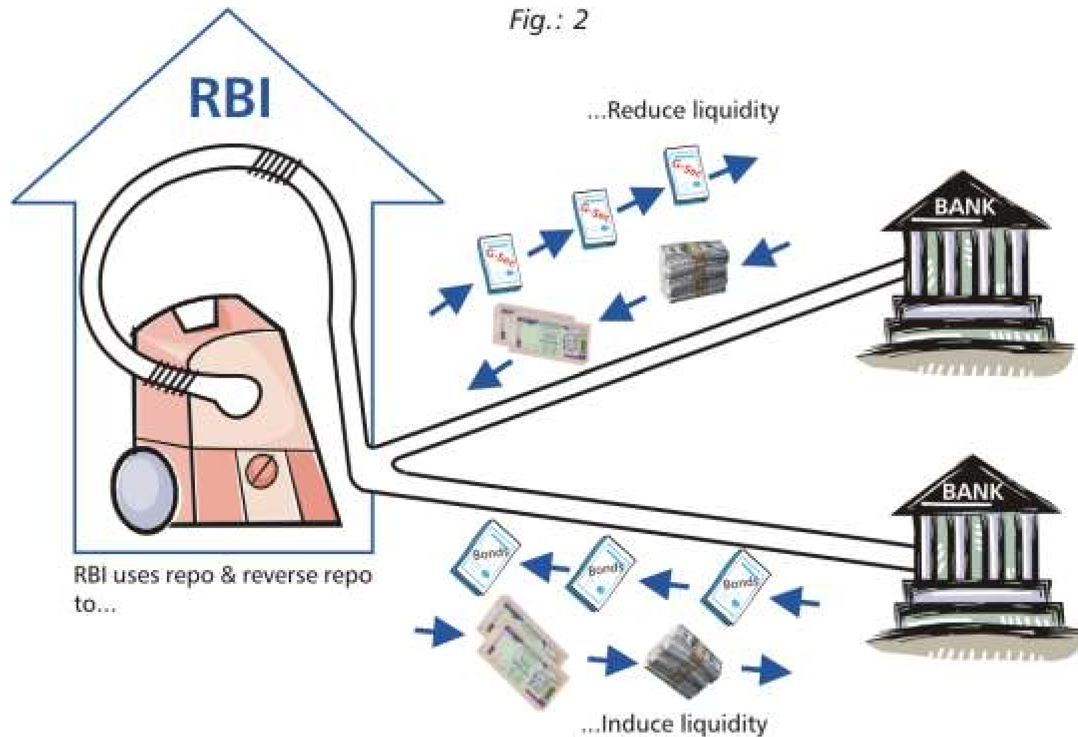
How does the monetary policy function?

The primary tool of the monetary policy entails managing the quantity of money in circulation through the buying and selling of various credit instruments, foreign currencies or commodities. All of these purchases or sales result in the increase or decrease of the base currency entering or leaving market circulation. The tools that are used by the RBI are as follows:

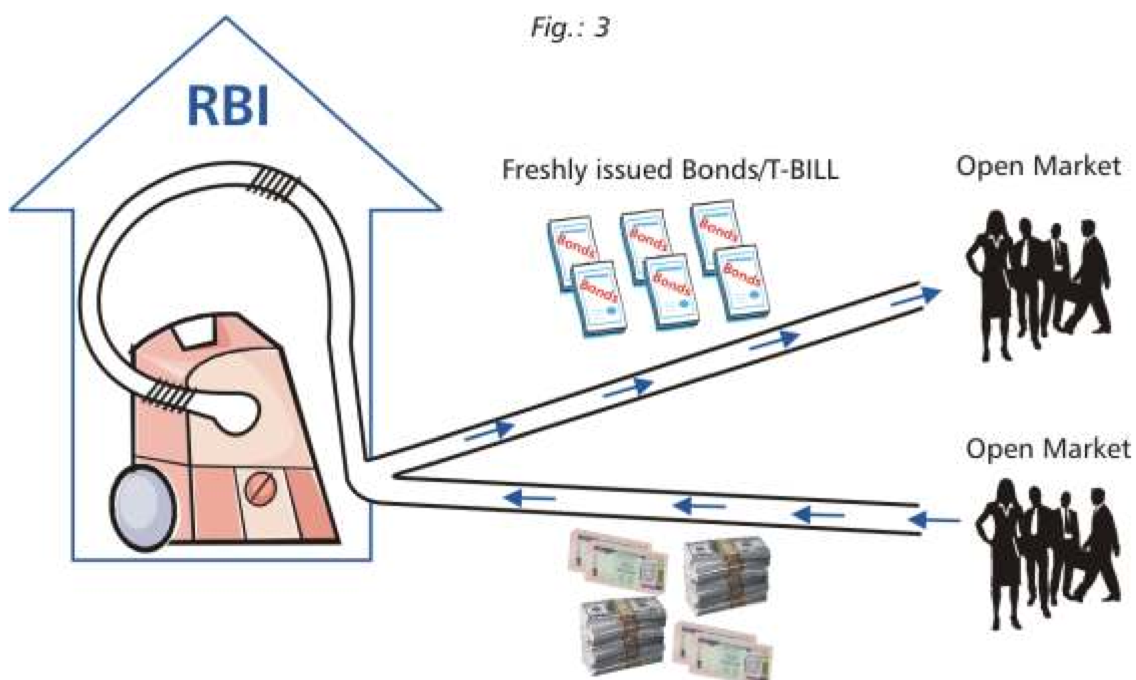
Fig.: 1



Increase / decrease in lending rates: From time to time, the RBI makes an adjustment in its lending rate (repo rate) in order to influence the cost of credit. By doing so it makes borrowing expensive, thereby discouraging borrowing. This brings about a reduction in the money in the system and helps lower the inflation rate. However a reduction in borrowing also slows down the economic growth and hence this method needs to be deployed after analyzing and understanding the impact of such a step on the economic growth. Due to this, the central banks resort to other methods as a means to the same end of lowering inflation.



LAF or Liquidity Adjustment Facility: It helps to inject & sterilize liquidity from the economy. Under this, the RBI conducts daily auction of repos & reverse repos to manage liquidity in the system. (Repo is the activity through which banks borrow money from RBI while reverse- repo is the activity through which the RBI absorbs excess money from the system).



In other words, if the RBI wants to reduce money supply, it will absorb money against security of government securities. On the other hand if RBI wants to inject money into the system it would do so in exchange for bonds that is available in the banking system.

MSS or Market Stabilization Scheme: Whenever liquidity in the system increases, the RBI intervenes to stabilize the system. The central bank does this by issuing fresh Bonds and Treasury Bills in the open market. By injecting the bonds and sucking out the excess money, the RBI contains the inflationary forces and cools the economy. This tool was used extensively at the time when dollar inflows into our economy were very high, resulting in rupee appreciation. In order to stabilize the exchange rates, the RBI first bought additional dollars thereby stabilizing the rate of exchange. The excess rupees for the dollar purchases was subsequently sterilized through MSS. The MSS is generally a short term action and is independent of the government's borrowing program.

CRR or Cash reserve ratio: CRR is the statutory requirements levied by RBI, for banks to set aside cash with the RBI. The reserve requirement is a bank regulation that sets the minimum cash reserves each bank must hold in order to meet withdrawal demands. It is defined as the percentage of total deposits that the bank holds as cash. The reserve ratio is sometimes used as a tool to contain inflation. By increasing the CRR, the RBI decreases the lending capacity of the bank to the extent of the increase in the ratio or vice versa.

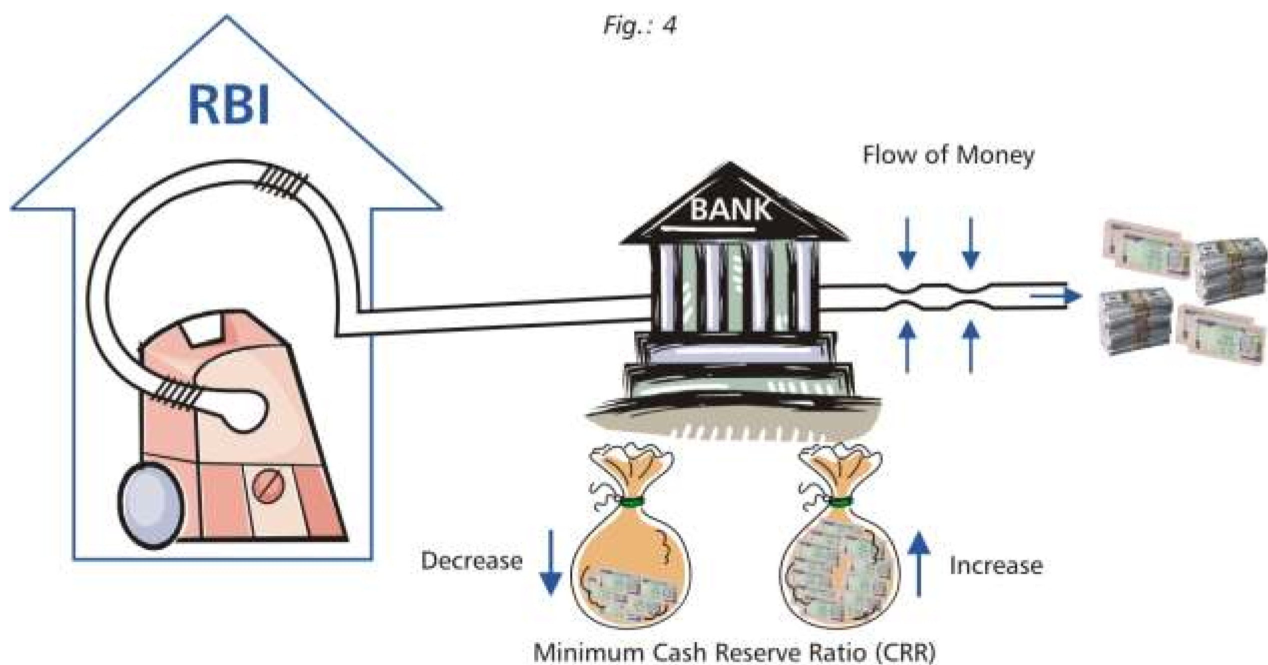


Fig.: 4

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